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## *Chinese Military Commerce and U.S. National Security*

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### ***Center for Asia Pacific Policy***

This is a final report of a project. It has been formally reviewed but has not been formally edited.

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#### **PREFACE**

This report attempts to evaluate the scale of Chinese military and defense-industrial commercial activity in the United States and the implications of this commerce upon the 1997 Most Favored Nation (MFN) debate as well as Sino-US relations writ large. It should be of interest to government and corporate decisionmakers in the U.S. and Asia, as well as academic researchers and other observers of the policy process.

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## SUMMARY OF FINDINGS

In recent years, the issue of Chinese military-affiliated companies operating in the United States has become an increasingly important policy concern. This report seeks to correct many prevailing misconceptions about these companies and clarify the key distinctions between military, defense-industrial and civilian companies. It also evaluates the implications of this commerce for U.S. national security.

The major empirical findings of this report are as follows:

- There are significant structural, sectoral and financial differences among military, defense-industrial and civilian companies operating in the United States, and these differences generally impede or prevent cooperation between the three types of firms;
- Purely military companies do in some cases subsidize the PLA, although these funds are used primarily to improve the living conditions of the troops and not to purchase foreign weapons systems;
- Defense-industrial companies do not directly subsidize the PLA, although the military receives indirect benefit from profits used to modernize China's defense-industrial base;
- Civilian Chinese companies, such as CITIC and COSCO, are not military companies, nor do all civilian companies serve as "fronts" for the PLA or the Ministry of State Security;
- Illegal arms importing by military and defense-industrial companies represents a threat to U.S. security, although there is currently no hard evidence that this trade is directed by the senior political leadership in Beijing;
- The acquisition of advanced dual-use technology by Chinese military and defense-industrial companies in the United States as well as technology "leakage" through U.S. joint ventures with companies in China pose the most serious national security concerns for the United States, although these activities are not as highly coordinated as recent media stories would suggest.

Despite the serious national security concerns they raise, this report argues that Chinese military and defense-industrial enterprises should be allowed to operate within the United States on the grounds that problems related to these companies do not appear sufficiently large to warrant the damage to Sino-US relations that would result from banning them. The United States' bilateral strategic relationship with China is arguably the most important in the post-Cold War world, and should not be disrupted by what are ultimately second-order issues that can be addressed in other ways. At the same time, desire for smooth relations with China should be balanced with the genuine security concerns posed by some Chinese commerce in the United States, including military companies. The United States government should clearly communicate to their Chinese counterparts that they are very concerned about these activities. Federal law enforcement agencies, including Customs, BATF, and the FBI, should redouble their efforts to identify and monitor these companies, as well as to prevent illegal behavior, especially in the areas of dual-use technology transfer. Any violations should be prosecuted to the fullest extent of the law, although any prosecutions or export exclusions should focus on the transgressing company and not the Chinese government writ large, unless there is clear evidence that high-ranking officials in Beijing were involved.

#### ACKNOWLEDGMENTS

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GLOSSARY, LIST OF SYMBOLS, ETC.

CDMA	Code Division Multiple Access
CITIC	China International Trust and Investment Corporation
COSTIND	Commission on Science, Technology and Industry for National Defense
GLD	General Logistics Department
GPD	General Political Department
GPS	Global Positioning System
GSD	General Staff Department
MFN	Most Favored Nation
MHz	Megahertz
NAFTA	North American Free Trade Agreement
PLA	People's Liberation Army
PRC	People's Republic of China
RDT&E	Research, Development, Testing and Evaluation
WTO	World Trade Organization

## 1. INTRODUCTION

In 1996 and early 1997, a series of events served to focus the attention of the American public on the commercial activities of the Chinese military in the U.S. domestic economy. The first of these was the March 1996 smuggling incident in Oakland, CA, where representatives of Chinese military and defense-industrial subsidiaries allegedly conspired to import 2000 AK-47 automatic rifles illegally into the United States. The second incident was the revelation in early 1997 that Wang Jun, a senior Chinese official with key military and business links, had visited the White House a year earlier to meet President Clinton. At the time of the visit, Wang was director of the China International Trade and Investment Corporation (CITIC) and Chairman of the Poly Group, a large arms-trading company subordinate to the People's Liberation Army's (PLA) General Staff Department and participant in the earlier smuggling incident. Although there is still no evidence that Wang's connection to Poly was in any way related to his coffee chat with President Clinton, the visit sparked a wave of interest among national newspapers concerning the extent of the PLA's commercial involvement in the United States.<sup>1</sup> These journalistic investigations have led members of Congress to call for hearings on the subject, and it is expected that the subject of Chinese military and defense-industrial commerce will now be an issue increasingly debated in Congress.

Thus far, however, the debate has been largely waged in the media, whose understanding of the Chinese bureaucracy and China's military-industrial system is limited. Many articles confuse military companies with defense-industrial and non-military companies, despite the fact that there are serious and important structural differences between them. Furthermore, the issue of profits and their final end-use have been grossly oversimplified. In particular, there is a disturbing lack

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<sup>1</sup> Conversations with knowledgeable people in Beijing suggest that Wang's visit was entirely superficial in purpose, as many businessmen in China crave the perception of personal power that is symbolized in a photo opportunity with the President of the United States.

of clarity regarding the relationship between profits earned in the U.S. by military companies and China's military modernization effort. If these issues are to be discussed intelligently in the context of Sino-US relations writ large, many of these structural concepts must be more accurately defined and contextualized. The goals of this CAPP working paper, therefore, are the following:

- Clarify the definitions of military, defense-industrial and civilian companies;
- Clarify the relationship between military and defense-industrial commerce and China's military modernization process;
- Evaluate the relative implications of Chinese military and defense-industrial commerce for U.S. national security, especially with regard to subsidization of the PLA and technology acquisition for military modernization;
- Assess the prudence and potential effectiveness of Congressional legislation designed to ban PLA and defense-industrial companies from operating in the United States.

To this end, this report seeks to shed light on the following sets of questions:

- What defines a Chinese military company? A defense-industrial company? A civilian company? What are the important similarities and differences between these companies? Between the military and defense-industrial systems in general? Do they coordinate? If so, how?
- Where do the funds generated by military or defense-industrial companies go? How much of the funds are repatriated back to China? How much remains in the hands of the foreign operation? In China, how are the funds distributed? What is their end-use?
- What is the scale of Chinese military and defense-industrial commerce in the US? How much is purely military? How much is defense-industrial? To what extent are these companies engaged in legal commerce? What forms does this commerce take? How much of their activities are illegal?

- What are the potential harmful effects, if any, of this commerce? What are potentially beneficial effects? Does this commerce threaten U.S. national security? First, does it subsidize the PLA? If so, what form does this subsidization take? Does it significantly alter the PLA's financial situation? Second, do these companies engage in legal and illegal technology acquisition to aid China's military modernization? Is this a concerted effort or does the process simply identify "targets-of-opportunity"? What is the capacity of the PLA to absorb this technology?

- What are the relevant bills being offered in Congress related to Chinese military and defense industrial companies? Is a ban a good idea? Would it be effective or would it do more harm than good?

This report does not exhaust the topic or answer these questions definitively, but hopefully clarifies the issues for the purposes of the national policy debate.

## 2. CHINESE COMPANIES: MILITARY, DEFENSE-INDUSTRIAL AND CIVILIAN

The most common mistake in the debate on Chinese military and defense-industrial commerce involves blurring of the definitions of what actually constitutes a Chinese military and defense-industrial company. Often, PLA-affiliated companies are spoken of interchangeably with Chinese defense-industrial companies, despite the fact that there are important differences between the two that have significant implications for any evaluation of their impact upon U.S. national security.<sup>2</sup> Even more disturbing, the various recent scandals have led some observers to tar all Chinese companies with a PLA brush, asserting that every company of PRC origin in the US is, to some extent, a "front" for the Chinese military.<sup>3</sup> This chapter will attempt to resolve these definitional problems by carefully delineating the various categories of Chinese companies, and assessing their level of activity in the United States.

### *Military Companies vs. Defense-Industrial Companies*

One of the most common mistakes in the analysis of Chinese military and defense-industrial commerce is the blurring of the distinction between military and defense-industrial companies, based on the incorrect assumption that the Chinese military and defense-industrial systems are one and the same. This misunderstanding has led some observers to conclude that the activities of Chinese military and defense-industrial companies operating in the U.S. are highly coordinated. Unfortunately, this depiction vastly oversimplifies the

<sup>2</sup> Timothy Maier, "PLA Espionage Means Business," Insight, 24 March 1997, pp.8-14; Timothy Maier, "'Silent Invasion' Marches Into Halls of U.S. Power," Insight, 17 March 1997, p.7-9. For example, John Fialka refers to the Chinese National Aero-Technology Import and Export Corporation (CATIC) as the "sister agency" of the People's Liberation Army. As explained below, this a highly misleading characterization of the bureaucratic relationship between these two institutions. See John J. Fialka, War By Other Means: Economic Espionage in America, (New York: W.W. Norton & Company, 1997), p.33.

<sup>3</sup> See especially Maier, "PLA Espionage Means Business," p.8.



complexity of the relevant bureaucracies, and displays a shallow and crude understanding of the relationship between the PLA and the defense-industrial ministries. To better understand these systems, a brief summary of their bureaucratic features is necessary.

Analytically, the military and defense-industrial institutional hierarchies should be categorized as two distinct systems containing elements of both cooperation and competition (see Figure 1<sup>4</sup>). The military side contains those institutions which can be considered "purely military," including the three General Departments (Staff, Political, Logistical), the Military Regions and Districts, and the active-duty and reserve forces of the Army, Navy, Air Force, and Strategic Rocket Forces. Each of these organs, within carefully defined parameters, has authority over a variety of economic enterprises. These enterprises, known as *jundui qiye* or "military enterprises," are formally affiliated with the PLA and engage in increasingly diversified and civilian-oriented commerce, both in China and abroad. While most PLA enterprises lose money, the successful ones pay a significant percentage of the profits from these enterprises as a tax to the General Logistics Department (GLD), and these monies are used to improve the living standards of the troops by raising wages, constructing new barracks, or supplementing the messing budget.<sup>5</sup> Because of corruption and discipline problems, the PLA has sought to impose stricter discipline on this business empire by consolidating the enterprises into centralized conglomerates established by the military regions, general departments,

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<sup>4</sup> Figure 1 is slightly incomplete. In 1995, DIA released an updated version of its defense-industrial trading companies chart that significantly expands the number of companies, adding new enterprises to nearly every bureaucratic organization. Therefore, this chart is only meant to represent graphically the structure of the two systems, specifically emphasizing the differences of control and coordination between the two sides of the firewall. For the newer chart, see Tim Maier, "PLA Espionage Means Business," pp.10-11.

<sup>5</sup> Many PLA enterprises are pre-1978 factories with bloated numbers of employees, whose social security burdens made them traditionally reliant on large amounts of government subsidies. Also, these factories generally are hampered by a lack of modern technology and insufficient plant flexibility to meet the new, more consumer-oriented needs of the market.

and group armies, as well as strengthen the oversight function over all such enterprises exercised by the GLD.

On the other side is the defense-industrial system, which is made up of civilian industrial ministries related to ordnance, aviation, space, shipbuilding, nuclear weapons, and electronics production. Each of these ministries has its own affiliated corporation, which concentrates on selling civilian and military-related output to both domestic and international markets. These corporations, whose constituent elements are known as *jungong qiye* or "military-industrial enterprises," are officially civilian in nature and operate within a chain of command that proceeds vertically from the enterprises through the ministerial leadership to the government's State Council, headed by the Premier.

[illegible]

Source: Adapted from U.S. Defense Intelligence Agency, *China's Defense Industrial Trading Companies*, VP-1920-271-90, September 1991.

The military and defense-industrial systems are separated by a high firewall, which was intentionally established to prevent the very lateral relationships now assumed by some Western observers. At the top of the firewall is the formal coordinating agency between the systems, often identified by its acronym COSTIND, which stands for the Commission on Science, Technology, and Industry for National Defense. COSTIND was founded in August 1982 by combining three defense organizations in an effort to bring more rationality and centralized decision-making to the development and output of Chinese military production.<sup>6</sup> COSTIND is formally charged with oversight on defense research, development, testing and evaluation (RDT&E), defense production/conversion, nuclear weapons testing, and satellite launches. It also has some input on arms control matters, relating to both international treaties and export controls. Bureaucratically, it serves two masters, the State Council and the Central Military Commission, acting as a bridge to coordinate R&D and procurement between military-industrial producers and PLA consumers.

This dual relationship has led some to assert that COSTIND is the pipeline through which profits from defense-industrial companies are funneled to PLA coffers. There is no direct evidence to support this claim. In fact, the available evidence suggests that the majority of earnings from defense-industrial companies remain on the defense-industrial side of the chart, divided between three general groups: the home factories, the superior ministry or COSTIND, and the companies themselves. According to one informed observer, a large percentage of the foreign earnings of defense-industrial companies are repatriated back to the factory or group of factories in China, in order to reinvest at the firm level, purchase new technology, or alleviate some of the social pressures currently drowning these factories in red ink, such as raising worker's wages and subsidizing other social security burdens.<sup>7</sup> The second major recipients are the traders themselves, who must pay for

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<sup>6</sup> This discussion of COSTIND is drawn largely from John Frankenstein and Bates Gill, "Current and Future Challenges Facing Chinese Defense Industries," *China Quarterly* 146, June 1996, pp.404-407.

<sup>7</sup> Conversation with Bates Gill, 2 May 1997.

the foreign operations base and often reward themselves with large official and unofficial commissions from the transactions. The final group of recipients, the superior ministry and/or COSTIND, may extract a tax from the factories, although this money is generally assumed to be a relatively small percentage of the overall pie. In the case of ministry-level receipts, these funds are believed to be used for a wide variety of legitimate and illegitimate purposes, ranging from modernization of industrial plant to the padding of the Swiss bank accounts of top ministry officials. For COSTIND, the case is much the same, although the funds might also be used to fund defense conversion activities, technology purchases, or R&D. With all of these "taxes," "commissions," and bureaucratic handouts along the way, it is very unlikely that any significant sums of money are transferred to the military side of the system.<sup>8</sup>

The implication of this military-defense industrial dichotomy is that these companies should be viewed as competing, not cooperating, for market access, technology, and profits in the United States and China as well. This contradicts the commonly-held assumption that these companies are either working together or are two parts of the same system. While there may be occasional collusion between elements of both systems, perhaps even facilitated by COSTIND, it is extremely difficult to assert that companies affiliated with the military and defense-industrial systems are partners in a larger commercially-oriented strategy, guided by the central military or political leadership in Beijing. According to Tai Ming Cheung, an expert on PLA commercialism, military and defense-industrial companies tend to have little interaction with each other in general, partly because of the separate bureaucratic structures in place but also because there is often little commercial advantage to working together, whether it is because they are competitors in a particular sector, such as chemicals, or because they are involved in unrelated activities in a given geographic area.<sup>9</sup> When the opportunity does arise

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<sup>8</sup> The issues surrounding the defense industry's financial contribution to the PLA is explored in more depth in Chapter 3, in the section entitled "Subsidization of the PLA."

<sup>9</sup> Personal communication, 5 May 1997.

for profits, military and defense-industrial companies form joint ventures to exploit the opening, although these are generally exceptions to the rule and often involve a civilian intermediary like CITIC or one of the non-defense industrial ministries. These linkages are explored in the next section.

#### *Non-Military/Defense-Industrial Companies*

Non-military affiliated companies make up a majority of the Chinese companies operating in the United States. Most of these enterprises are subsidiaries of the trading corporations of China's large ministries and state-owned enterprises (SOEs). While some of these organizations might have significant dealings with the PLA or the defense-industrial complex, they are distinct from these systems in several important respects. To illustrate the differences between military and defense-industrial and civilian companies, two companies that have been incorrectly identified with the PLA are examined.

The China International Trust and Investment Corporation, or CITIC, was founded in 1979 by the "Red Capitalist" Rong Yiren to serve as the government's window on foreign investments and technology. CITIC is a civilian investment concern under China's governmental State Council. It became identified with the PLA as a result of the scandal surrounding Wang Jun and his visit to the White House on 6 February 1996. Because Wang is both director of CITIC and Chairman of Poly Group, the arms trading company of the General Staff Department, some have concluded that CITIC is really controlled by the PLA or that Wang Jun uses his dual appointment to effectively merge the two organizations.<sup>10</sup> Actually, well-informed sources in Beijing confirm that Wang Jun's role in Poly Group is titular at best, and that the day-to-day decisionmaking within the organization is handled by its president, He Ping.<sup>11</sup> Wang Jun spends the vast majority of his time dealing with business related to CITIC, whose interests are overwhelmingly civilian in nature, including

<sup>10</sup> Maier, "'Silent Invasion'," p.8.

<sup>11</sup> Interviews in Beijing, February 1997.

investments in infrastructure, real estate, manufacturing, banking, retail, and trade.<sup>12</sup>

While CITIC does enter into business partnerships with and provide logistical assistance to PLA and defense-industrial companies like Poly, this does not mean that CITIC is controlled by the PLA. According to Tai Ming Cheung, CITIC, at least before the early 1990s, served primarily as a source of capital for these firms, as it did for many civilian companies. It was also a conduit for military sales and acquisitions on behalf of the General Staff Department and a dumping ground for loss-making defense plants which the central government wanted to be made profitable. These activities were generally not directly related to its civilian business. Over time, CITIC has begun concentrating less and less on these governmental and military investments, largely because these were not profitable. This is especially true of its business relationship with Poly. For a number of years after its founding in 1984, Poly was officially listed as a subsidiary of CITIC because CITIC was an original shareholder in the company, but also to disguise its true relationship to the PLA from Western observers. By the early 1990s, however, Poly's true parentage was revealed.<sup>13</sup> Today Poly is an independent corporation and there are very few commercial or institutional ties between Poly and CITIC apart from Wang Jun's status in both. While areas of residual interest remain, the trend is towards increasing separation and clarification of functions based on such things as stock holding arrangements.

The second civilian company incorrectly identified with the PLA is the Chinese Ocean Shipping Company (COSCO), primarily because of its role in the shipment of 2000 AK-47s to the United States. National security concerns about COSCO were further heightened by its proposal to build a US\$200 million container terminal on the site of the former Long Beach Naval Station.<sup>14</sup> The available evidence suggests, however, that

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<sup>12</sup> For an excellent discussion of CITIC, see Daochi Tong, "Commercial Power Centers: China," (Santa Monica, CA: RAND, forthcoming 1997).

<sup>13</sup> Tai Ming Cheung, "Arms Reduction: The PLA's Main Weapons Dealer Goes Civilian," Far Eastern Economic Review, 14 October 1993, p.68.

<sup>14</sup> See "Security Review of Base Sought," Washington Post, 13 March 1997, p.16; Jeff Leeds, "Congressman Tries to Sink Plan for Long Beach Port,"

these fears are probably unfounded. First, shipping companies are not responsible for inspecting the contents of containers put aboard their vessels and are prevented from tampering with them. Containers are sealed before they are loaded aboard and delivered sealed at the other end. Those shipping a container provide the shipper with a document declaring the contents of the container and a copy of a customs declaration which matches this information. The shipping company loads the cargo and, in return for documentation also originated by those shipping the container, unloads it and releases it to consignee for customs clearance at the port of entry. While COSCO was technically a party in the operation, the criminal elements are those who made the false declaration and those who wittingly sought to receive the contraband goods in Oakland. Second, conversations with Federal law enforcement officials confirm that COSCO has been lawfully operating out of the Long Beach port for more than 16 years, as well as its facilities at 9 other U.S. ports.<sup>15</sup> There is no reason to suspect that it would operate any differently if it constructed a container terminal in Long Beach. While the job of U.S. officials might be made more difficult with the establishment of a Chinese facility, all arrivals and departures would still be subject to U.S. Customs inspection, and the responsibility for the veracity of individual shipments would reside

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Los Angeles Times, 21 March 1997; Jeff Leeds, "Long Beach Port Plan Faces Rising Tide of Criticism," Los Angeles Times, 24 March 1997; Jeff Leeds, "Harbor Panel OKs Terminal for Chinese Line," Los Angeles Times, 25 March 1997; "Official Business: Congressmen Defend Chinese Port Business," Los Angeles Times, 26 March 1997; "Feinstein, Husband Hold Strong Chinese Connection," Los Angeles Times, 28 March 1997; "Judge Orders Commission to Reconsider Port Project," Los Angeles Times, 12 April 1997; "Ruling Could Kill Port Deal for Long Beach," Los Angeles Times, 13 April 1997; "Harbor Panel Votes to Cancel China Shipping Company Lease," Los Angeles Times, 15 April 1997; "Port Cancels Lease With Chinese Firm," Los Angeles Times, 22 April 1997; . The Long Beach Harbor Commission says the new lease to COSCO, which has had a presence in the port for 16 years, would create 1,600 construction jobs over 1 1/2 years, 600 permanent shipping jobs once completed and several hundred jobs elsewhere in the city. The port would receive about \$20 million a year in lease payments, while the city stands to reap about \$1 million more in taxes annually.

<sup>15</sup> Allegedly, the Federal Maritime Commission is investigating allegations of predatory pricing by the company.



with those sending and receiving the goods, not the shipping company that transports them. In line with this analysis, a Department of Defense review recently concluded that "no significant national security concerns" were raised by COSCO's plan to acquire the Long Beach base.<sup>16</sup>

#### *Chinese Military and Defense-Industrial Companies in the United States*

The true scale of Chinese military and defense-industrial commerce in the United States is a matter of some considerable debate among analysts inside and outside of the United States Government. The method of counting is important, because many of these companies are layered within hierarchies of offshore shell companies and often have similar mailing addresses. Regardless of the actual number, however, the trends clearly suggest that this number is growing, all but ensuring that this issue will be a source of political conflict into the foreseeable future. The remainder of this section will be devoted to discussing the organizational and financial features of a cross-section of these companies. Military and defense-industrial companies will be examined separately, for the reasons outlined above.

#### *PLA-Affiliated Companies*

Each service branch and general department of the PLA has its own enterprises and conglomerates, each of which has the potential capability of establishing subsidiaries in the United States. Currently, it is estimated that there are between 20-30 PLA-affiliated companies operating in the United States, although there are certainly more that have not yet been identified. One of the primary obstacles to identifying PLA-affiliated companies in the U.S. is that they often consciously disguise their military background by using offshore holding companies and unfamiliar names. Given the recent political backlash on this issue, we can expect this obfuscation to become increasingly common.

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<sup>16</sup> "Pentagon Says COSCO Doesn't Imperil Security," Washington Times, 23 May 1997, p.6.

Of the U.S.-based companies identified, two of the most successful are subsidiaries of Poly, which is controlled by the General Staff Department, and Xinxing, owned by the General Logistics Department.<sup>17</sup> Because of the scandal over Wang Jun's visit to the White House in February 1996, the Chinese military company Poly Group has been heavily scrutinized by the U.S. media and law enforcement. The China-based parent company, Poly Technologies, Ltd., was founded in 1984, ostensibly as a subsidiary of CITIC, although it was later exposed to be the primary commercial arm of the PLA General Staff Department's Equipment Sub-Department.<sup>18</sup> Throughout the 1980s, Poly sold hundreds of millions of dollars of largely surplus arms around the world, exporting to customers in Thailand, Burma, Iran, Pakistan, and the United States. Officially, Poly received a commission from these arms sales, with the rest going to the General Logistics Department. These sales peaked in 1987, when Poly sold more than US\$500 million in weapons. With the entry of the Russians onto the international arms market, however, Poly's arms trading profits dipped sharply, forcing it to diversify into civilian business activities like property development.

Until 1996, the primary Poly subsidiary in the U.S. was PTK International, Inc. of Atlanta, run by Poly's representative in the States, Baoping "Robert" Ma. PTK International was a joint venture company incorporated in 1987 in the State of Georgia with Poly Technologies, Inc. owning 75% of the stock.<sup>19</sup> The primary legal business of PTK was the importation and distribution of semi-automatic rifles for the U.S. domestic market. These rifles, which were drawn from the PLA's extensive stockpiles, were lower-quality copies of Russian designs and

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<sup>17</sup> Carrie Enterprises, the trading company attached to the PLA General Political Department, allegedly runs a company in Brooklyn, New York that imports bullet-proof vests and other goods. China Songhai Industrial Corporation, a conglomerate owned by the Chinese navy, allegedly runs China Songhai Industrial Corporation of Los Angeles. China Zhihua Corporation, a conglomerate of the General Staff Department, allegedly runs Zhihua Corporation, USA and Bintao Corporation, USA, both in Alhambra, CA.

<sup>18</sup> This account is drawn largely from Tai Ming Cheung, "Arms Reduction," p.68.

<sup>19</sup> The remaining 25% was owned by David Keng, a resident of Atlanta, Georgia.

extremely inexpensive compared with their Western and Russian counterparts. Between 1987 and 1993, PTK sold more than US\$200 million worth of these guns in the United States. This market was officially ended in May 1994, when President Clinton signed an executive order banning further gun imports from China, but loopholes allowed importers to bend the rules. Specifically, Congress exempted weapons in transit *post hoc*.<sup>20</sup> The U.S. Treasury initially estimated that this exemption would cover 12,000 weapons, but importers actually brought in 41,000.<sup>21</sup>

Apart from PTK International, Poly's operations in the U.S. quickly diversified into a series of subsidiaries and holding companies (see Table 1).

Table 1. Poly's Operations in the U.S., 1988-96

Company Name	Date of Incorporation	Date of Dissolution
PTK International	5/7/87	8/6/96
Dynasty Holding Co.	3/4/88	8/6/96
Poly USA, Inc.	6/4/92	5/11/94
Dynasty Holding Co. of Atlanta, Inc.	6/4/92	5/11/94
J F & D International	7/2/92	?
H & D International	1/19/93	8/6/96
Novell International	3/31/95	?

Source: Lexis-Nexus Secretary of State database

In 1988, Poly Technologies 75% stake in PTK was transferred to Dynasty Holding Company, a wholly-owned U.S. subsidiary of Poly. Dynasty handled all incoming and outgoing money for Poly, including management of all Poly investments in the U.S., and coordinated procurement of defense-related materials with PTK and U.S. firms. Allegedly, Dynasty illegally shipped some of these materials, including advanced radar systems, minicomputers, and advanced communications equipment for use in the

<sup>20</sup>Fialka, War By Other Means, p.189.

<sup>21</sup> "Chinese Weapons Flow Into U.S. Despite Clinton's Ban," Dow Jones News Service, 7 April 1995. In May 1995, exactly one year after the ban, U.S. Customs agents discovered that 75 million rounds of ammunition had been illegally imported into the U.S. from sources in China and Russia. See "Ammunition Seized," Associated Press News Service, 4 May 1995.

PLA's UH-60 Blackhawk helicopters, to China under the guise of non-restricted merchandise.<sup>22</sup>

Poly's U.S. subsidiaries were abruptly closed in August 1996, as the indictments were issued in the AK-47 smuggling case. Allegedly, Poly's representative, Robert Ma, conspired with China North Industries Corporation's (NORINCO) representative, Richard Chen, and a number of businessmen in California to illegally import 2000 AK-47s into the United States.<sup>23</sup> Unfortunately for them, their "customers" turned out to be undercover U.S. Customs and BATF agents, posing as members of a Miami syndicate. Poly's representative, Robert Ma, fled the country one step ahead of Federal law enforcement officials who had a warrant for his arrest, and his current whereabouts are unknown.<sup>24</sup>

The second major PLA company with interests in the United States is China Xinxing (Group) General Corporation, owned by the General Logistics Department (GLD).<sup>25</sup> Subordinate to it are domestic companies involved in medical science and technology, mine products, chemicals, real estate development, automobile production, and shipping. According to official company materials, these companies control over 100 industrial and mining enterprises in China, located in more than 20

<sup>22</sup> Interview with senior law enforcement official.

<sup>23</sup> For the full text of the indictment, see United States of America v. Hammond Ku, et al., Indictment of the Grand Jury, 4 June 1994, (N.D.CAL., 1996). The alleged conspiracy between Poly and NORINCO reps does raise questions about the strength of the firewall between the military and defense-industrial systems in China. However, this case seems to be an exception, and could possibly be explained by three factors: (1) Chen and Ma may have had a personal relationship which facilitated the cooperation, possibly through common military service; (2) Poly's superior, the General Staff Department equipment sub-department and NORINCO's previous configuration, the former Ministry of Ordnance, have a historically close relationship, which may have permitted cooperation at lower levels; and (3) the validity of the Chinese bureaucratic model may be less appropriate for enterprises outside of China because of the variation in foreign contexts and distance from governing authorities in Beijing.

<sup>24</sup> It is unclear whether Poly has established any new U.S.-based operations.

<sup>25</sup> The General Logistics Department also controls Sanjiu (999) Group, which is a major producer of pharmaceuticals in China. Sanjiu runs three confirmed companies in the United States: 999 Nan Fang (U.S.A.), Inc. and South Spirits, Inc, both in Milbrae, CA, as well as Shanghai Sanjiu (999) Real Estate in Inglewood, CA.

provinces and cities. These enterprises engage in both military and civilian trade for domestic consumption, producing uniforms, textiles, leather goods, footwear, medical and pharmaceutical products, machinery, iron, steel and chemicals. In addition, promotional materials show that Xinxing Group's export company, the China Xinxing General Import-Export Corporation, exports automobile shock absorbers, truck parts, automobiles, touring buses, salt, iron and steel, mining ores, medicines and pharmaceuticals, medical instruments, stoves, hair tonic, sewing machines, pneumatic tools, bulldozers, textiles, leather goods, and animal products to over 1000 industrial and commercial enterprises in more than 100 countries and regions. Xinxing Group's subsidiary in the United States is Xin Xing (U.S.A.), whose main headquarters is located in an industrial park in El Monte, California. A listing of Xin Xing (U.S.A.)'s possible other operations can be found in Table 2 below:

**Table 2. Alleged Xinxing Companies**

Company Name	City, State	Incorporation	Dissolution
Jiangsu Xinxing Chemicals Group	Brighton, MI	1/11/94	7/15/96
U.S.-Xinxing Int'l, Inc.	Los Angeles, CA	1/23/97	
Xin Xing (USA)	El Monte, CA	12/16/94	
Xinxing-American Int'l, Inc.	New York, NY	7/27/95	
Xinxing Int'l Group, Houston, Inc.	Houston, TX	3/31/95	2/19/97
Xinxing Int'l Trading Corp.	Long Island City, NY	8/11/93	
Xinxing Sun Win Asia Co, Ltd.	New York, NY	2/3/97	

Source: Lexis-Nexus Secretary of State database

Although the relationship between these companies and Xinxing (USA) is still unclear, some commonalties have begun to emerge, particularly with regard to their sectoral interests. At least one of the Los Angeles companies deals in medicines and pharmaceuticals, which is one of the primary production interests of GLD factories, as outlined above.

Additionally, Xinxing owns a bonded warehouse near the Long Beach Naval Station.

#### Defense-Industrial Companies

The most important defense-industrial company operating in the United States is NORINCO, which stands for the China North Industries Corporation. NORINCO was founded in 1988, succeeding the Ministry of Ordnance in overseeing China's tank, artillery, munitions, and small-arms factories. As of 1993, NORINCO is believed to have controlled 157 large and medium-sized enterprises employing nearly 800,000 personnel, including 30 research and development centers, more than a dozen technical colleges and 60 overseas companies.<sup>26</sup> Most of the larger enterprises, whose total fixed assets are estimated at RMB60 billion, were located in inland provinces, such as Sichuan, forming the bulk of Mao's "Third Line."<sup>27</sup> Many of these enterprises are perennially in the red, and have had a difficult time converting to civilian production. The more successful enterprises have concentrated on civilian pursuits, such as vehicle production (60%), turning out mini-vans, heavy trucks, and coach buses. Other non-military production activities include chemicals (15%), optics (20%), motorcycles, railway cars, and bicycles. NORINCO's military production, on the other hand, has been in significant decline since the 1970s.

Like its PLA counterparts, NORINCO has achieved moderate success with joint ventures and foreign subsidiaries. Between 1983 and 1993,

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<sup>26</sup> Tai Ming Cheung, "Elusive Ploughshares: Chinese Defense Plants Turn to Civilian Production," Far Eastern Economic Review, 14 October 1993, pp.70-71.

<sup>27</sup> The "Third Line" refers to a defensive strategy of industrialization authorized by Mao Zedong in the 1960s. It called for the construction of a massive, self-sufficient defense-industrial base deep in the mountains of China's southwest, so that in the event of U.S. or Soviet attack, they could provide output to China's guerrilla army. This policy is estimated to have absorbed RMB 140 billion between 1963 and 1975, and is responsible for many of the conversion difficulties faced by the Chinese defense industry. See Barry Naughton, "The Third Front: Defense Industrialization in the Chinese Interior," China Quarterly 115, September 1988, pp.351-86.

NORINCO received more than US\$200 million in foreign investment and established more than 100 joint ventures within China. It has also invested in foreign land deals, taking a 40% share in a US\$77.22 million Thailand land deal with Hong Kong's Liu Chong Hing Bank.<sup>28</sup> At the same time, NORINCO has established at least 11 subsidiary operations in the United States. Alleged subsidiaries are listed in Table 3.

**Table 3. Alleged NORINCO Companies in the United States**

Company Name	City, State	Products
Beta Chemicals	Cerritos, CA	chemicals
Beta First	Cerritos, CA	optics
Beta Toys, Inc.	Santa Fe Springs, CA	toys and hobby goods
Beta Unitex	Fontana, CA	machinery, chemicals
China North Industries	Baton Rouge, LA	ammunition?
Forte Lighting, Inc.	Fontana, CA	lighting fixtures
Larin	Ontario, CA	auto parts
Livex Lighting	Fairfield, NJ	chandeliers
NIC International Trade, Inc.	Fairfield, NJ	ammunition
NIC Max	Fairfield, NJ	auto parts, truck springs
NIC Sports	Seacaucus, NJ	sporting goods, leather goods
Sunico Industries	Santa Fe Springs,	stone tiles, optics

Source: Lexis-Nexus Secretary of State database

While this is not a complete list, it presents a fair picture of NORINCO interests in the U.S., especially in the aftermath of the 1994 U.S. ban on semi-automatic weapons, which forced the company to change its focus from arms importing to non-military sectors. Like Xinxing, NORINCO responded by establishing subsidiaries whose commercial interests largely mirror those of NORINCO factories in China, especially with regards to vehicle parts, chemicals, optics, and leather goods. Beta Toys has even registered trademarks with the United States Patent and Trademark Office to protect the following brands: Nutco, Swan, The Pot Bellies, Pot Belly Bear Wear, Prestige, Sunshine Teddy, Soft Dreams, and NE-Animals.

<sup>28</sup> "Norinco's Long Arm," Far Eastern Economic Review, 7 September 1989, p.12.

### *Conclusions*

In general, there are important differences between military and defense-industrial enterprises operating in the United States, both with respect to the chain of command and the distribution of financial profits. Military enterprises are affiliated with the purely military system, including combat units, headquarters departments, and service branches, while defense-industrial enterprises are subsidiaries of China's civilian defense-industrial ministries. By contrast, the civilian companies operating in the U.S. are often genuinely civilian in nature, although they may occasionally come into contact with either military or defense-industrial firms. Both military and defense-industrial enterprises operate subsidiaries in the United States, often engaging in business related to the sectoral interests of the parent factories or enterprises in China. Lateral coordination between these two systems is facilitated by COSTIND, but such cooperation is rare for both bureaucratic and competitive reasons. Over time, the number of these businesses operating in the U.S. will probably increase, but it is equally likely, given the current political climate, that they will downplay their military or defense-industrial affiliation.



### 3. CHINESE COMMERCE AND U.S. NATIONAL SECURITY

The three commonly stated dangers to U.S. national security posed by Chinese military and defense-industrial commerce involve its potential subsidization of the PLA, the acquisition of advanced technology, and illegal arms smuggling into the United States. These topics will be examined in depth in the next three sections.

#### *Subsidization of the PLA*

One of the most common criticisms of permitting Chinese military and defense-industrial commerce to operate in the U.S. is that such commercial activity provides a direct subsidy to the Chinese military.<sup>29</sup> This is perceived as objectionable for two reasons, one moral and the other strategic. Some observers, primarily ideological opponents of the Chinese regime, morally object to this alleged subsidization because they perceive the PLA to be an instrument for the suppression of dissent within China. To bolster their position, they point to the PLA's suppression of pro-democracy protesters in Beijing in June 1989. For these advocates, the commercial presence of PLA and defense-industrial companies in the United States should be curtailed because their profits add to the coffers of the "Butchers of Beijing."

The strategic argument against PLA subsidization, on the other hand, is generally offered by a very different group of people, some of whom are supportive of the "engagement policy" and cultivation of long-term strategic relations with the Chinese government.<sup>30</sup> These observers object to PLA subsidization on the grounds that it undermines U.S. national security, viewing any augmentation of China's military capabilities as potentially detrimental to the interests of the United States. Even those who believe that the rate of improvement in Chinese

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<sup>29</sup> See Maier, "PLA Espionage Means Business," pp.8-14; Maier, "'Silent Invasion'," p.7.

<sup>30</sup> This "strategic" group includes elements of the first, although these two groups can be separated by the strength of their belief in the "China threat" thesis.

capabilities is still far below that of the United States still find legitimate reason to be concerned about the increased financial capability of the Chinese military, created by trade in the United States, to acquire key "levelers" and denial weapons, such as long-range cruise missiles, that might threaten U.S. forces in the region.

To answer the question of whether profits from PLA and defense industry-affiliated companies subsidize the military in any significant way, it is first necessary to examine briefly the fiscal history of the PLA and the history of the military-business complex since the beginning of the reform period. In the late 1970s and early 1980s, Deng Xiaoping, driven by the need to increase the rate of investment in state sectors as well as to modernize the military, slashed the defense budgets of the PLA and embarked on a relatively draconian policy of streamlining the armed forces. Throughout the 1980s, the defense budget declined in real terms (see Figure 2), while the number of military personnel was cut by more than 1 million men. Even when the central government reversed the PLA's budgetary trend and began increasing the budget by double-digit increments after 1989, runaway inflation largely muted the effect, giving the PLA perhaps only a 4% annual gain (see Figure 2).

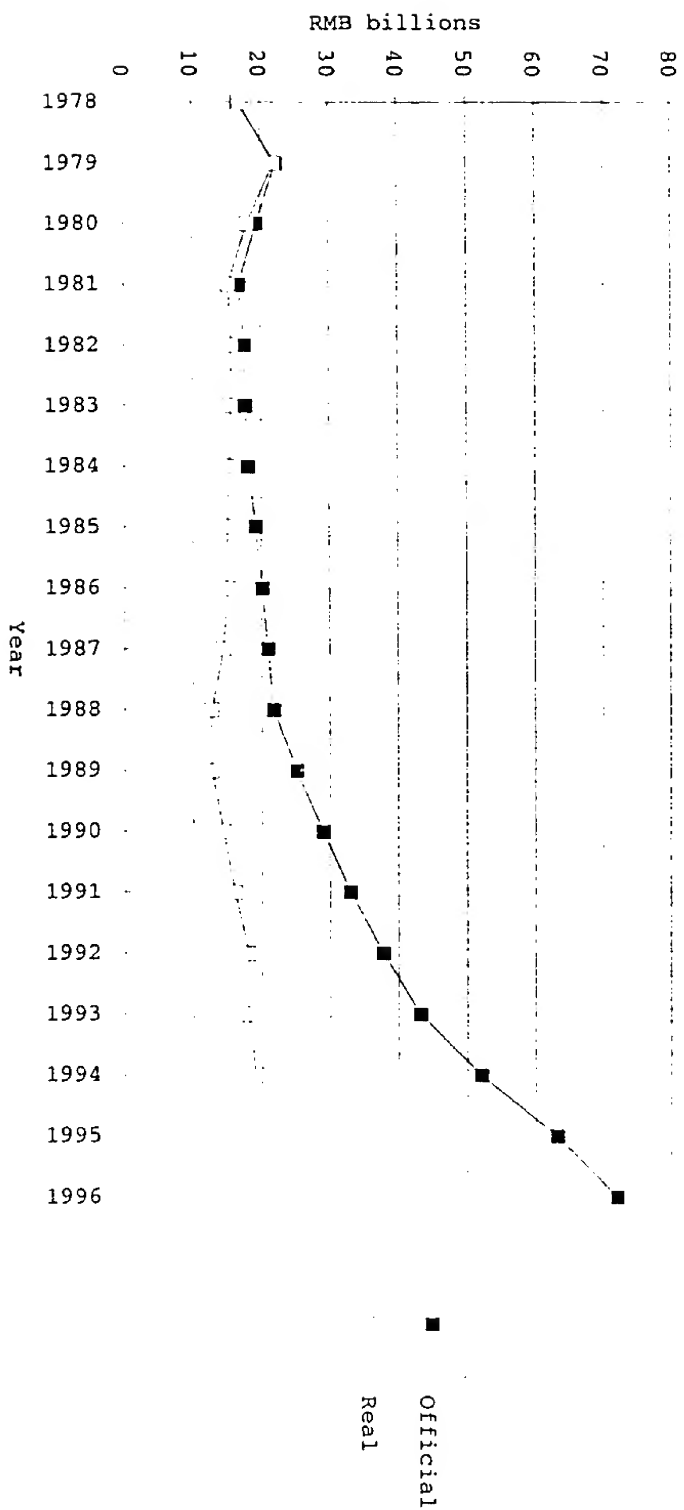


Figure 2. PRC Official Defense Budget in Nominal and Constant 1978 RMB, 1978-95  
 (Source: Paul Humes Folta, From Swords to Plowshares: Defense Industry Reform in the  
 PRC, China Statistical Yearbook, 1996)

While no serious analyst of the PLA accepts the official numbers as the actual defense budget of the PLA, which is most commonly estimated between US\$30-36 billion<sup>31</sup>, it is nevertheless clear that the PLA regards its financial situation as less than optimal, as repeatedly evidenced in the internal military press.<sup>32</sup>

### Military Commerce

In order to replace some of these lost budgetary allocations and improve their fiscal status, military units in the mid-1980s were encouraged to expand their economic production activities, which had previously been limited to agriculture and some sideline production.<sup>33</sup> According to Tai Ming Cheung, PLA factories were told to convert from military to civilian production, major trading corporations were established, and previously banned areas of economic activity, such as

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<sup>31</sup> See Richard Bitzinger and Lin Chong-pin, "Off the Books: Analyzing and Understanding Chinese Defense Spending," (paper presented at the 5th Annual AEI Conference on the People's Liberation Army, Staunton Hill, 17-19 June 1994); David Shambaugh, "The Defense Budget," (paper presented at the IISS/CAPS Conference entitled "Chinese Economic Reform: The Impact on Security Policy," Hong Kong, 8-10 July 1994); Wang Shaoguang, "Demystifying China's Defense Expenditure," (paper presented at the 6th Annual AEI Conference on the People's Liberation Army, Coolfont, West Virginia, 9-11 June 1995); and Arthur Ding, "China's Defense Finance: Content, Administration and Future Development," China Quarterly 146, June 1996, pp.428-442.

<sup>32</sup> For example, see Wang Haibo, "Junfei jiegou ji qiyouhua [Structure of Military Spending and Optimization of It]," Junshi jingji yanjiu [Military Economic Studies], June 1992, (Wuhan, PRC: Military Economics Institute), pp.31-34; Chen Yirao and Zhou Qinbin, "Jundui yusuan guanli zouxiang [Budget Management Trends in the Army]," Junshi jingji yanjiu [Military Economic Studies], May 1994, (Wuhan, PRC: Military Economics Institute), pp.36-37; and Beijing Military Region Logistics Bureau Party Committee Standing Committee, "Ruhe zuohao 'guojin rizi' zheipian wenzhang [Doing Our Best to Pull Through Austerity]," Junshi jingji yanjiu [Military Economic Studies], February 1996, (Wuhan, PRC: Military Economics Institute), pp.4-11.

<sup>33</sup> This section draws heavily from Tai Ming Cheung's excellent history of the rise of the military-business complex. See "The Chinese Army's New Marching Orders: Winning on the Economic Battlefield," in Jörn Brömmelhörster and John Frankenstein, eds., Mixed Motives, Uncertain Outcomes: Defense Conversion in China, (Boulder: Lynne Rienner, 1997), pp.181-204.

the tertiary industry (hotels, etc), were opened up to military enterprises. Between 1985 and 1993, the number of these military enterprises grew rapidly, doubling to perhaps as many as 20,000 firms. While two-thirds of pre-reform PLA industrial enterprises remain in the red, some of the new tertiary firms, like hotels and real estate development, posted impressive financial gains, declaring revenue equivalent to 10-15 percent of the official defense budget. This suggests that the PLA can expect to receive between RMB8-12 billion (US\$1.2-1.4 billion) in gross revenues, of which maybe RMB4-6 billion (US\$480-720 million) are profits. These revenues have increased by approximately 15% annually since 1986. Of course, these official figures for gross revenue and profits most likely underrepresent the actual earnings of military enterprises, since underreporting is a pervasive problem among local units and has led to repeated audits by bureaus of the General Logistics Department.

Where do these profits go and what are they used for? Most analysts believe that military enterprises are permitted to keep a substantial proportion of their earnings. According to Tai Ming Cheung, the amount retained varies according to the type of military enterprise and the profitability of the operation, but they are generally able to retain 20-40 percent of their profits for reinvestment and other uses. The remaining monies are divided between the General Logistics Department (40-60%), regional and provincial military authorities (10-20%) and the local PLA unit that owns the enterprise (10-20%). The profits passed to the local PLA unit, in turn, are diverted to two general areas. Some of the money is used for training, as well as to improve the living standards of the troops, including barracks construction and repair, food subsidies, and medical coverage. Other funds, however, are used for more corrupt purposes, such as paying for lavish meals, expensive foreign luxury automobiles, and Swiss bank accounts.

Overall, PLA companies therefore make a significant, if less flashy, contribution to the fiscal strength of the military, by augmenting the GLD's capacity to increase wages, maintain facilities,

and improve a host of other "quality-of-life" issues.<sup>34</sup> For those who oppose any subsidization of the PLA, there is thus ample evidence that profits from PLA-affiliated enterprises directly benefit the main-line forces of the Chinese military, although the actual amount is not very substantial in the context of the overall budget.

#### Defense Industrial Commerce

By contrast, defense-industrial companies make little if any direct financial contribution to the PLA, for bureaucratic reasons outlined in the previous chapter. To say that the profits from defense-industrial companies do not end up in the coffers of the PLA is not to say, however, that these profits never benefit the military. In fact, it could be argued that the profits of these companies often provide a variety of indirect benefits to the military and its modernization. For instance, the profits or technology acquired by China North Industries Corporation (NORINCO) might be used to modernize China's ordnance industrial base, which would improve the quality of small arms and vehicles eventually delivered to the military. Additionally, the civilian commercial earnings or acquired technology of the China State Shipbuilding Corporation (CSSC) or the Aviation Industries Corporation of China (AVIC) might indirectly benefit Chinese naval and combat aircraft programs.<sup>35</sup> Finally, the profits from defense-industrial sales might help cover their losses on sales to the PLA, which would extend the value of the PLA's defense budget. This is a long way from saying, however, that profits from defense-industrial companies like NORINCO are directly channeled to the PLA to be used for force modernizations or foreign military purchases.<sup>36</sup> Expensive weapons systems, such as those purchased from the Russians, are usually paid for with barter output

<sup>34</sup> To the extent that these funds free up O&M funds or other budget items, they also increase the buying power of the existing defense budget.

<sup>35</sup> At a higher level, the PLA might benefit from any technology obtained by or R&D carried out by COSTIND, especially if these advances trickled down to the defense industry as a whole.

<sup>36</sup> Fialka, p.186.

from PLA factories or hard currency from special capital accounts under the State Council allocated for specific contacts.

### *Technology Acquisition*

The second, and potentially much more serious, negative consequence of Chinese military and defense-industrial commerce is the acquisition of advanced technology for China's military modernization. This concerns observers on all points of the China policy spectrum, because it relates to issues of dual-use and economic espionage in the United States. Indeed, there is a significant and growing amount of evidence that this type of activity occurs via all manner of Chinese companies operating both in the U.S. domestic economy and abroad.<sup>37</sup> For example, former Wall Street Journal reporter John Fialka, in his recent book War By Other Means, claims that 450 Chinese companies on the West Coast are under Federal investigation for illegal technology transfer, although it is by no means clear that all these companies are dealing with the PLA.

For the bureaucratic reasons outlined in Chapter Two, however, one must resist the temptation to impute a conspiratorial angle to this behavior, even with regard to military and defense-industrial companies. Despite evidence of conspiracy in isolated cases, it is still more likely that military and defense-industrial companies operate semi-autonomously, entering whatever market sector they are able to penetrate in search of profit. When targets-of-opportunity present themselves, especially with regard to particularly critical pieces of dual-use technology, other parties, such as COSTIND and the Ministry of State Security, might be alerted. The evidence suggests that this phenomenon, while serious and growing, is still relatively limited in scale, and law-abiding Chinese companies should not be lumped together with those violating the law. One of the dangers of this latter attitude is that it will foster the perception that all Chinese companies, and by extension all Chinese-Americans who do business with China, should be considered

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<sup>37</sup> John J. Fialka, War By Other Means; Kenneth R. Timmerman, "Chinese Spy Openly At Weapons Fair," Washington Times, 24 March 1997, p.1

guilty until proven innocent, which will only exacerbate the atmosphere of paranoia and suspicion in the overall relationship.

Nonetheless, there is very real and troubling evidence of attempts to acquire dual-use technology by Chinese companies in the United States.<sup>38</sup> In December 1995, two Chinese-Americans and one PRC national were indicted for conspiring to export items needed to make artillery fuses.<sup>39</sup> According to U.S. investigators, the two Chinese-American owners of Brighty Company, Penny Ray (Lei Ping) and James Lee (Li Jin), conspired with Wu Dinggao, an employee of China North Industries Corporation (NORINCO) to ship 15,000 blade cutters plus a die mold to a military factory in China that was building an artillery-fuse production line. The components were successfully shipped to China in December 1990, mislabeled as "G-dest" (general destination) for nonmilitary exports, which is a violation of U.S. customs law. Apparently, the couple had first aroused the suspicion of law enforcement authorities when they tried in 1992 to purchase surplus silicon chip manufacturing equipment from Litton Industries, Inc.'s Solid State Division and export it through the China Electronics Import-Export Corporation to the Hebei Semiconductor Research Institute in Shijiazhuang, which was believed by U.S. intelligence agencies to provide critical components to nuclear weapons facilities. Although that deal was blocked by agencies within the United States government, investigators checked the past history of Brighty Co. and found the 1990 sale of artillery-fuse components.

The Brighty Co. case is symptomatic of a much larger phenomenon, wherein Americans and PRC nationals, knowingly or otherwise, help China buy defense-related equipment, usually at bargain prices, from public auctions or sales by the nation's largest defense contractors, such as Lockheed Martin Corporation, General Electric Company, and General Dynamics Corporation. These purchases have been greatly facilitated by

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<sup>38</sup> John J. Fialka, War By Other Means. See also Nicholas Eftimiades, Chinese Intelligence Operations, (Annapolis, MD: Naval Institute Press, 1994).

<sup>39</sup> More detailed accounts of these dual-use transfers are found in Robert Greenberger, "Let's Make A Deal: Chinese Find Bargains in Defense Equipment As Firms Unload Assets," Wall Street Journal, 21 October 1996, p.1.



the end of the Cold War and the resulting shrinking of the defense industry, which placed billions of dollars of surplus equipment on the open market. In 1996, four Chinese officials from Chengdu, the site of numerous aircraft and defense-industrial facilities, purchased \$190,000 worth of machine tools from Northrop Grumman's Glen Arm facility, which once produced parts for B-1 bombers and F-14 Tomcats.<sup>40</sup> If the equipment had been new, it would have been worth closer to \$800,000, although old machining equipment can be easily upgraded with modernized computer systems costing between US\$50,000 and US\$100,000. Most such purchases are legal, but exporting them to China under false pretenses is a violation of U.S. Customs law. For example, Yuchai America, the Cleveland, Ohio subsidiary of China Yuchai International, China recently settled U.S. government charges that it tried to export two sophisticated five-axis machine tools purchased from the Heinz Corporation (jet engine manufacturer for the Pentagon), without a proper license and filed false and misleading export documents.<sup>41</sup> The shipment was detained in May 1994 and the subsidiary settled the complaint for \$200,000 in civil penalties without admitting guilt.<sup>42</sup>

On the other side, American companies in China sometimes seek to transfer dual-use technology to their Chinese partners, some of whom have military connections.<sup>43</sup> The most well-known example involves McDonnell-Douglas' joint venture relationship with the China National Aero-Technology Import and Export Corporation (CATIC).<sup>44</sup> In late 1996, a GAO investigation concluded that sophisticated machine tools, sold to the Chinese for use in the production of commercial aircraft parts, had been illegally transferred to AVIC's Nanchang Aircraft Factory, a

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<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

<sup>42</sup> Ibid. The company was eventually allowed to ship the machines in late 1995.

<sup>43</sup> The Chinese have even enlisted former government officials to help them. Retired General Richard Secord, a member of the Reagan national security team, helped COSTIND's Yuanwang Corporation to create Technology Selection Inc. in Mountain View, California, which plans to acquire dual-use technology and ship it to China.

<sup>44</sup> This account is largely drawn from "Export Controls: Sensitive Machine Tool Exports to China," GAO/NSIAD-97-4, (Washington, DC: United States General Accounting Office, November 1996).

defense-industrial factory which produces fighter aircraft and cruise missiles for the PLA as well as a variety of civilian products. According to knowledgeable technical officials, this equipment, which had been used in a Columbus, Ohio plant to assemble Titan and MX missiles, would have significantly upgraded the capacity of the Chinese aircraft or missile industry to produce high-tolerance components.<sup>45</sup> As Allen and Pollack point out in their book on the Chinese air force, it is deficiencies in precisely these areas that have effectively stymied the indigenous Chinese aircraft modernization program.<sup>46</sup>

Four other serious potential dual-use cases involve the transfer of advanced telecommunications technology to China. The most notorious was the sale of broadband telecommunications technology to HuaMei Communications, Ltd., a joint venture between SCM Brooks Telecommunications, a limited U.S. partnership, and Galaxy New Technology, a Chinese company whose primary shareholder was COSTIND.<sup>47</sup> The equipment in question consisted of Asynchronous Transfer Mode (ATM) and Synchronous Digital Hierarchy (SDH) products, which are to be used ostensibly for a broadband telecommunications network among several hotels in Guangzhou, China. Technical experts agree, however, that this ATM and SDH equipment could be used to significantly upgrade the Chinese military's backward but improving C3I (command, control, communications, and intelligence) capabilities. Given the military connections of COSTIND, there was a perception that this advanced telecommunications equipment might be transferred to the PLA, much like the machine tools from McDonnell Douglas. Similarly, the sale of the material itself was legal, as long as the material was not diverted to other end-uses. In fact, the new General License category (GLX) for the AT&T equipment did not even require a validated license from the Commerce Department. As a result, the equipment was successfully exported in 1994 to China.

<sup>45</sup> See Fialka, War By Other Means, pp.29-40. Fialka writes that the machines were so big they required 275 truckloads to ship them from Columbus, Ohio to a waiting Chinese freighter on the West Coast.

<sup>46</sup> Ken Allen, Glenn Krumel, Jonathan Pollack, China's Air Force Enters the Twenty-First Century, MR-580-AF, (Santa Monica, CA: RAND, 1995).

<sup>47</sup> This account is largely drawn from "Export Controls: Sale of Telecommunications Equipment to China," GAO/NSIAD-97-5, (Washington, DC: United States General Accounting Office, November 1996).

More recent cases involve foreign companies that seek to exploit the PLA's control of a wide swatch of China's available telecommunications bandwidth, but also promise the transfer of advanced technology to the PLA for use in commercial systems. In the booming wireless telecom market, San Mateo's International Wireless Communications has recently invested US\$20 million and committed another US\$28 million for a 40% stake in a subsidiary of Hong Kong's Star Telecom, which plans to help the PLA build new cellular phone networks in China.<sup>48</sup> Hutchison Whampoa of Hong Kong, controlled by Hong Kong billionaire Li Ka-shing, is also negotiating for PLA wireless system contracts, which would build upon his equity interest in Poly-owned Yangpu Land Development Company, which is building infrastructure on China's Hainan Island.<sup>49</sup>

One of the largest PLA telecommunications deals involves China Telecom-Great Wall Mobile Communications, which is a joint venture between Beijing Telecommunications Administration (BTA), the state phone company owned by the Ministry of Posts and Telecommunications (MPT), and the Telecommunications Development Department of the China Electronic System & Engineering Company (CESEC), controlled by the Telecom Bureau of the General Staff Department's Communications Department. This joint venture permits foreign investors to exploit a 10MHz-wide portion of the military's broadcast bandwidth for commercial purposes. As a result, every major global telecommunications equipment company, including AT&T/Lucent, Motorola, Northern Telecom, and Ericsson, are bidding for the opportunity to fill procurement contracts for the dozens of province-level operations that will make up the Great Wall system. In exchange for access to this bandwidth, however, the PLA and its partners expect a significant infusion of capital and technology. Motorola Asia Pacific Cellular Infrastructure Group (APCIG) has recently signed a US\$300 million contract to supply a trial CDMA network in Beijing.<sup>50</sup> CDMA, or Code Division Multiple Access, is an advanced technology that

<sup>48</sup> Karl Shoenberger, "Joining Forces with China's PLA," Fortune, 3 February 1997, p.48.

<sup>49</sup> Ibid., p.50.

<sup>50</sup> China Telecom Report, International Technology Consultants, Vol.4, No.3, 27 March 1997, p.12.

permits high-volume communication in a small area, with limited interference from other traffic. It was originally designed for military communications applications in rear areas. Motorola APCIG will deploy 30 of its SC 2450 base stations and an EMX 2500E large capacity switch for the CDMA network, which will have a 43,000 subscriber capacity. The project is expected to be completed in 1997.

Perhaps the most troubling potential transfer to China, however, concerns Rockwell's proposed joint venture deal with the Shanghai Broadcast Equipment Factory and the Shanghai Avionics Corporation, the latter of which is a key enterprise of the Aviation Industries of China.<sup>51</sup> The limited liability joint venture firm, known as Shanghai Rockwell Collins Navigation and Communications Equipment Company, Ltd., will design, develop, and build Global Positioning System (GPS) navigation receivers systems for the Chinese market.<sup>52</sup> These components have serious dual-use implications, since the acquisition of reliable GPS data can enhance, to varying degrees, the capacity of militaries to field highly accurate cruise and ballistic missiles, such as those used to intimidate Taiwan during March 1996.<sup>53</sup> More accurate GPS systems would enhance the PLA's ability to carry out attacks against Taiwan's military and industrial facilities, potentially reducing the ability of the Taiwanese military to defend itself against PRC coercive diplomacy. Furthermore, the use of GPS to enhance the accuracy of long-range Chinese cruise missiles, coupled with long-range sensors, would raise serious concerns for the U.S. Seventh Fleet in the Pacific, and possibly

<sup>51</sup> "Rockwell Agrees to Form Joint Venture With Chinese Firms to Design, Manufacture, and Market Commercial GPS in China," Rockwell Home Page (<http://www.rockwell.com/>).

<sup>52</sup> In fairness, it must be noted that similar GPS systems are available on the open market.

<sup>53</sup> Scott Pace, et al, Global Positioning System: Assessing National Policies, MR-614-OSTP, (Santa Monica, CA: RAND, 1995); Gerald Frost and Irving Lachow, Satellite Navigation-Aiding for Ballistic and Cruise Missiles, RP-543, (Santa Monica, CA: RAND, 1996); Irving Lachow, "The GPS Dilemma: Balancing Military Risks and Economic Benefits," International Security, Summer 1995, Vol.20, No.1, pp.126-148; and Gerald Frost and Irving Lachow, GPS-Aided Guidance for Ballistic Missile Applications: An Assessment, RP-474-1, (Santa Monica, CA: RAND, 1996).

circumscribe their ability to provide an effective deterrent in a crisis over Taiwan.

For any of these technology transfers to be meaningful, however, the Chinese must be able to absorb and reproduce these advanced technologies. Heretofore, the defense industry has a very spotty record in this area. In fact, some analysts have concluded that China's recent spate of "off-the-shelf" purchases from the Russians are a direct consequence of the inability of China's defense-industrial base to either reverse-engineer or indigenously develop advanced weapons systems in sufficient numbers or quality. Overall, the consensus among observers of the Chinese defense industry seems to be that the defense industry is generally incapable of absorbing most advanced foreign technology, much less reproducing copies at the same tolerances and quality standards. This weak point may explain the desire of the defense-industrial complex to acquire advanced machining tools, such as those involved in the McDonnell-Douglas scandal, and establish joint-ventures with foreign firms that will transfer the production capacity and technology to China. These types of acquisitions are far more valuable to the defense industry, and by extension the PLA, than the theft or purchase of any system, no matter how advanced, because "[machine tools] are the stepping stone to much bigger things..."<sup>54</sup>

#### *Illegal Arms Smuggling into the United States*

The AK-47 smuggling incident discussed above raises troubling questions about the desirability of allowing Chinese military companies to operate in the United States, in particular the extent to which the incident reflects a concerted strategy by officials in China. The U.S. Attorney in Oakland argues that higher-level officials must have known, given the sensitivities in the Chinese government concerning control of weapons exports and the participation of high-level cadre children ("princelings"), such as Deng Xiaoping's son-in-law He Ping, in the arms

<sup>54</sup> Fialka, War By Other Means, p.35.

trade. In the 100pg indictment and affidavit from one of the key undercover agents, significant attention is paid to the fact that the Chinese had difficulty getting the barrels for the guns, since the barrels required higher-level permission. In the minds of the prosecutors, this implies that the factory-level officials in Dalian needed to contact their superiors, either at the NORINCO office in Beijing or the General Staff Department.

However, the conclusion of the U.S. Attorney is based on the increasingly less tenable assumption that the Chinese government has strong controls over all arms exports and that Poly and NORINCO officials are fully aware of the activities of their subordinates. In fact, the structural trends in China during the reform period, in particular the emphasis on decentralization and fiscal autonomy, suggest that the Chinese authorities have increasingly less control over arms exports, except perhaps in the case of extremely critical strategic systems. Poly's executive director Xie Datong, who was also listed as a corporate officer of PTK International's Dynasty Holding Company in Atlanta, is on record as saying that the transfer of small arms does not always require authorization from the General Staff Department, even in the case of transfers of stockpiled weapons from General Logistic Department-controlled warehouses.<sup>55</sup>

#### *Chinese Military-Affiliated Commerce and Congress*

Incidents such as those described above have, since 1994, raised concern in the United State Congress about Chinese military and defense-industrial commerce in the United States. In July 1994, the House Ways and Means Committee held a hearing to discuss HR 4590, whose text declares:

The People's Republic of China's defense industrial trading companies and the People's Liberation Army engage in lucrative trade relations with the United States and operate lucrative commercial businesses within the United States. Trade with and investments in the defense industrial trading

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<sup>55</sup> Tai Ming Cheung, "Arms Reduction," p.68.

companies and the People's Liberation Army are contrary to the national security interests of the United States.<sup>56</sup>

To deal with these companies, the bill suggested the following policy:

It is the policy of the Congress that, since the President has recommended the continuation of the waiver under section 402(d) of the Trade Act of 1974 for the People's Republic of China for the 12-month period beginning July 3, 1994, such waiver shall not provide for extension of nondiscriminatory trade treatment to goods that are produced, manufactured, or exported by the People's Liberation Army or Chinese defense industrial trading companies or to nonqualified goods that are produced, manufactured, or exported by state-owned enterprises of the People's Republic of China.<sup>57</sup>

As noted, many of these companies act as importers and distributors for products manufactured by their home factories in China. MFN denial for these companies would have increased the tariffs on this trade.

In 1996, HR 3684 was offered in the Subcommittee on Trade under the House Ways and Means Committee by a group of Congresspeople long associated with opposition to MFN rights for China, including Reps. Benjamin Gilman (R-NY), Tom Lantos (D-CA), Gerald Solomon (R-NY), Christopher Cox (R-CA), Floyd Spence (R-SC), Henry Hyde (R-IL), Christopher Smith (R-NJ), Frank Wolf (R-VA), Ed Royce (R-CA), Dan Burton (R-IN), and Nancy Pelosi (D-CA). Unlike the 1994 bill, HR3684 sought to "prohibit the importation into the United States of goods produced, manufactured, or exported by the People's Liberation Army of China or any Chinese defense industrial trading company," which was a significant change from merely denying these companies MFN privileges.

In 1997 it is expected that an anti-PLA bill will be put forward, although this bill, sponsored by Senator Spencer Abraham, may only target companies attached to Poly Group or NORINCO. While this measure appears to have a slightly higher chance of passing, it has greatly angered the more extreme factions of the anti-PLA coalition, who argue that the bill is too watered-down and too narrow in focus. In particular, the opponents of the Poly-NORINCO bill object to the exclusion of companies like Xinxing and others, which are clearly PLA-

<sup>56</sup> H.R. 4590 "United States-China Act of 1994," 104th Congress.

<sup>57</sup> Ibid.

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affiliated but have not received the same level of notoriety as Poly or NORINCO. The supporters of the bill counter that a Poly-NORINCO bill is a good start, and might allow American law enforcement to score some victories before moving on to the more difficult cases.



#### 4. CONCLUSIONS

The major U.S. national security concerns related to Chinese military commerce are the potential subsidization of the PLA, the acquisition of advanced technology, and illegal arms importing. With respect to the first issue, profits from PLA enterprises do provide fiscal benefit to the military, although primarily to improve areas related to "quality-of-life," such as wages, facilities, and messing. Because of bureaucratic impediments, profits from defense-industrial enterprises provide only indirect benefits to the PLA, largely through potential reinvestment in the industrial base. Second, there are serious national security concerns posed by the acquisition of advanced technology by Chinese military and defense-industrial companies in the United States as well as U.S. joint ventures with companies in China. There are disturbing reports of transfers in the areas of telecommunications, which could potentially benefit the PLA's C3I capability, and GPS, which could significantly enhance the accuracy of ballistic and cruise missiles. The most potentially dangerous transfers, however, might be those related to production technology (i.e., machine tools), since they could improve the capability of China's lackluster defense-industrial base to absorb many other types of foreign advanced technology. Finally, illegal arms importing continues to be a law enforcement concern, although there is currently no hard evidence of direction by the senior political leadership in Beijing. Of these three areas of national security concern, technology transfer is the most serious, particularly given the lack of a COCOM framework for U.S. export controls and the poor track record of both U.S. and Chinese companies in this area.

Despite the serious national security concerns raised in this report, Chinese military and defense-industrial enterprises should be allowed to operate within the United States because problems related to these companies do not appear sufficiently large to warrant the damage to Sino-US relations that would result from banning them. The United States' bilateral strategic relationship with China is arguably the most

important in the post-Cold War world, and should not be disrupted by what are ultimately second-order issues that can be better addressed in other ways. At the same time, desire for smooth relations with China should be balanced with the genuine security concerns posed by some Chinese commerce in the United States, including military companies. The United States government should clearly communicate to their Chinese counterparts that they are very concerned about these activities. Federal law enforcement agencies, including Customs, BATF, and the FBI, should redouble their efforts to identify and monitor these companies, as well as prevent illegal behavior, especially in the areas of dual-use technology transfer. Any violations should be prosecuted to the fullest extent of the law, although any prosecutions or export exclusions should focus on the transgressing company and not the Chinese government writ large, unless there is clear evidence that high-ranking officials in Beijing were involved.<sup>58</sup>

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<sup>58</sup> The U.S. government's handling of the recent case involving two Chinese companies that allegedly shipped chemical weapons precursors to Iran is an excellent example of this strategy and should be used as a template for future incidents.

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